

3. (a) Define the following terms indicated in bold in the text:

(i) **entrepreneurship (paragraph ①)** [2 marks]

level

0 *Wrong definition* 0

1 *Vague definition* 1

The idea that it is a factor of production.

2 *Precise definition* 2

An explanation that it is the factor of production involving organizing of the other factors and/or risk taking.

(ii) **monetary policy (paragraph ②).** [2 marks]

level

0 *Wrong definition* 0

1 *Vague definition* 1

The idea that it is a policy concerned with controlling the amount of money in the economy.

2 *Precise definition* 2

An explanation that it is a demand-side policy using changes in the money supply or interest rates to achieve economic objectives relating to inflation and unemployment.

**N.B.** Candidates may explain that it is a demand-side policy, using changes in interest rates, to shift the AD curve. This is sufficient for L2.

- (b) Using an appropriate diagram, explain the likely effect of aggregate demand increasing “beyond potential output” (*paragraph 1*). [4 marks]

level

- |   |   |            |
|---|---|------------|
| 0 | <i>Inappropriate answer</i>   | <b>0</b>   |
| 1 | <i>Identification of appropriate theory</i><br>For drawing a correctly labelled AD/AS diagram which shows AD and SRAS intersecting to the right of LRAS <b>or</b> for explaining that if AD increases beyond potential output, the effect would be inflation.       | <b>1-2</b> |
| 2 | <i>Correct application of appropriate theory</i><br>For drawing a correctly labelled AD/AS diagram which shows AD and SRAS intersecting to the right of LRAS <b>and</b> for explaining that if AD increases beyond potential output, the effect would be inflation. | <b>3-4</b> |

Candidates who incorrectly label diagrams cannot be rewarded with full marks.

For AD/AS, the vertical axis may be price level or average price level. The horizontal axis may be output, real output, national output, real national output, national income, or GDP. A title is not necessary.

Candidates may illustrate their answer using either a Keynesian aggregate supply curve or a business cycle showing output gaps. If correctly explained they should be fully rewarded.

- (c) Using an AD/AS diagram, explain how wage increases create cost push inflation (*paragraph ②*). [4 marks]

level

0 *Inappropriate answer* 0

1 *Identification of appropriate theory* 1-2

For drawing a correctly labelled AD/AS diagram, which shows a leftward shift of SRAS and higher price level **or** for explaining that wages are a cost of production and that higher wages will lead to higher production costs which will be passed on in the form of higher prices leading to cost push inflation.

2 *Correct application of appropriate theory* 3-4

For drawing a correctly labelled AD/AS diagram, which shows a leftward shift of SRAS and higher price level **and** for explaining that wages are a cost of production and that higher wages will lead to higher production costs which will be passed on in the form of higher prices leading to cost push inflation.

Candidates who incorrectly label diagrams cannot be rewarded with full marks.

For AD/AS, the vertical axis may be price level or average price level. The horizontal axis may be output, real output, national output, real national output, national income, or GDP. A title is not necessary.

- (d) **Using information from the text/data and your knowledge of economics, evaluate the consequences for Iceland's economy if it maintains tight monetary policies.**

**[8 marks]**

Responses **should** include:

- an explanation of tight monetary policy.

Possible positive consequences include:

- a reduction in the inflation rate (*Figure 2*)
- an appreciation of the currency, making imports cheaper.

Possible negative consequences include:

- a lower rate of economic growth (*Figure 1*)
- a worsening of the current account deficit as the exchange rate increases (*Figure 3*)
- increased unemployment (*Figure 4*)
- a fall in the growth rate of *per capita* income (*paragraph 1*)
- a reduction in the rising entrepreneurship (*paragraph 1*)
- changes in the distribution of income.

Effective evaluation may be to:

- consider short-term versus long-term consequences
- examine the impact on different stakeholders
- discuss advantages and disadvantages
- prioritize the arguments.

Examiners should be aware that candidates may take a different approach which if appropriate, should be rewarded.

If there is no direct reference to the text/data, then candidates may not be rewarded beyond level 2.

#### **Level**

0	No valid discussion.	<b>0</b>
1	Few relevant concepts recognized. Little discussion or only basic understanding.	<b>1-2</b>
2	Relevant concepts recognized and developed in reasonable depth. Some attempt at application and analysis.	<b>3-5</b>
3	Relevant concepts developed in reasonable depth, demonstrating effective evaluation, supported by appropriate evidence or theory.	<b>6-8</b>